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November 26, 1996

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Federal Communications Commission
Office of Secretary

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

EX PARTE: **Federal-State Joint Board on Universal Service**
CC Docket No. 96-45

Dear Mr. Caton:

Today I provided copies of the attached speech to Pete Belvin of Commissioner Quello's office, Jim Casserly of Commissioner Ness' office, Dan Gonzalez of Commissioner Chong's office and to John Nakahata of Chairman Hundt's office. Copies of this letter also will be provided to the service list issued in this proceeding with the November 18, 1996 Public Notice seeking comment on the Joint Board's Recommended Decision.

Please call me if you have any questions.

Sincerely,

Whitney Hatch

Attachment
c: CC Docket 96-45 Service List

No. of Copies rec'd 0+1
List ABCDE

◆ **NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS**
Annual Convention
San Francisco, CA
November 19, 1996

◆ **LEE SCHMIDT**
Chairman-United States Telephone Association
and
Vice President-Industry Affairs
GTE Telephone Operations

THE UNIVERSAL SERVICE RECOMMENDATION: NOT READY FOR PRIME TIME

Twelve days ago, the Joint Board released its much-anticipated recommendation to reform the nation's system to ensure universal telephone service. Unfortunately, it leaves unanswered critical policy questions and heads down the wrong path on those that it does address. To help assess the wisdom of the Joint Board's recommendation, let's review how the present universal service system came to be.

How is universal service achieved today?

Universal service is achieved today through regulation that is guided by the following mechanisms:

1. Imposing on LECs obligations to serve a specified geography, which requires them to invest in those areas that are economically unattractive at prices allowed by regulation.
2. Allocating costs among jurisdictions and among services, which achieves politically acceptable prices, regardless of the actual costs of providing universal service. Attaining economically efficient prices has historically ranked way down the list as a regulatory objective.
3. An averaging of costs which leads to an averaging of prices that are politically acceptable.
4. Through a high-cost fund, supporting some LECs which have high average costs compared to the nation-wide average.
5. Providing need-based programs, such as Lifeline and Link Up, to offer universal service for the economically disadvantaged.

How is universal service provisioned today?

Real people build real houses where they want them, not where it would be more efficient to place telecom facilities. Old houses are abandoned, leaving facilities that are no longer needed. New houses get built, but not necessarily where the LEC has facilities. Hills, rivers, lakes, bedrock, and lava flows are where they are — not where it would be more efficient to install facilities. LECs use whatever current technology is then available when they build facilities to meet their obligation to serve.

As long as incumbent LECs have an obligation to serve — which means an obligation to make capital investments — regulation has a responsibility to assure the opportunity to recover that capital.

Some argue that capital recovery cannot be assured in a competitive market. However, in a truly competitive market, participants voluntarily make their own investment choices. Under the rules being created, regulators continue to impose investment obligations on LECs. If government has the right to require uneconomic investments, government needs to be willing to accept responsibility for the recovery of such investments. Otherwise, the coercive power of government would result in nothing less than confiscation.

Given the existing system, what's the goal of universal service reform?

The Joint Board's goal was to update the universal service fund, or USF, in a competitively neutral manner to prepare the local exchange market for robust competition. The updated USF must meet the needs of traditional constituencies, such as high-cost areas and low-income households. But, it also must address new targets like schools, libraries, and rural health care providers.

The present system actually provides an estimated $21 billion a year in subsidies to make universal service available at today's prices. The high-cost fund, Lifeline, and Link Up programs provide explicit support of about $1 billion. LECs raise the remaining 95% of support implicitly through higher rates for other services. Businesses, urban customers, access, toll, and vertical services are currently the primary sources of this subsidy, which, by regulatory design, keeps down the price of basic local service. But, the Telecom Act requires an elimination of such implicit support.

Let's not forget that the new beneficiaries of universal service support — education and health care — would increase the total tab for universal service beyond $21 billion. For schools alone, the Joint Board recommends spending up to $2.25 billion a year to wire every classroom in America. Universal service support to libraries and rural health care providers would increase costs even more.

How large should the USF be?

The answer is simple — the Telecom Act says that the USF should be sufficient. There may be powerful pressure to regulate away the size of the fund to what some might find to be a more politically acceptable level, and the Joint Board recommendation appears to be doing just that.

The fund's size will be determined by the shortfall between a national revenue benchmark and the cost to provide universal service. On the revenue side of the equation, the Joint Board suggests a benchmark that would include revenues from not only local exchange service, but also access and discretionary services. Yet, the Act says to do away with implicit support. To do that, it makes sense to attribute only revenues from local exchange services for the support of universal service. Including revenues from access and discretionary services perpetuates undesirable, and now inappropriate, implicit subsidies. The Telecom Act clearly requires that implicit support for universal service be transformed into explicit support via a new universal service fund.

Now, let's look at the other side of the equation — the cost of providing universal service. Proxy cost models can be useful if they are used to disaggregate highly-averaged actual costs into highly-deaveraged actual costs. Proxy models used in this way can better target high cost support to where it's actually needed. On the other hand, proxy models are not useful if they are used to pretend that actual costs somehow do not exist. After all, current LECs' universal service costs have continuously passed the "used and useful" test with regulators across the country. Forward-looking costs may be useful when measuring appropriate prices for <u>newly-built</u> infrastructure. But, they are not useful when measuring appropriate prices for the use of <u>existing</u> infrastructure.

In a typical proxy model, workers are always healthy, equipment always functions, and all residences and businesses are exactly alike and efficiently located. Not surprisingly, the costs of a hypothetical network may not bear a strong resemblance to actual costs.

Looking at both sides of the equation, if regulation intentionally low-balls a LEC's costs and high-balls its revenues, there won't be much USF support to worry about. And, if this outcome occurs, one has to question whether the sufficiency standard of the legislation is achieved.

Who will pay into the new universal service fund?

The Joint Board says that carriers providing interstate telecom services should pay into the new fund. This would include IXCs, LECs, wireless companies, and any other carriers providing interstate services. This is a good start, since this expands the current base.

However, the decision that USF payments should be based on a carrier's total telecom revenues, <u>net</u> of its payments to other carriers for telecom service, does not meet the Telecom Act's principle of requiring equitable and nondiscriminatory contributions. The flaw in this decision is that the LECs — who provide basic transport services for other carriers that can net out their payments for those services — wind up paying the lion's share into the fund.

Bearing such a large burden, LECs will be forced to drastically raise local service prices or continue implicit subsidies. Yet, implicit subsidies are to be replaced according to the Telecom Act. It is far wiser to spread the burden equitably at this time and place all competitors on the same footing.

Another concern is the Joint Board's reluctance to allow carriers to pass the universal service assessments on to consumers through a surcharge on bills. FCC Chairman Reed Hundt noted at the press conference after adopting the Joint Board's recommendation that, "We voted to have telecommunications companies contribute money to a fund from their own revenue."

But, carriers can only get revenues from their customers. So, if carriers are not allowed to pass these costs on to consumers, the Joint Board's action could result in confiscation.

Instead of wringing out implicit subsidies in existing rates and creating fully-funded explicit support mechanisms, the Joint Board tries to jump-start competition by continuing to rely on LECs to not only deliver universal service at prices that do not cover their costs, but also to pay for it.

Who will receive universal service support?

The Joint Board recommends that any carrier willing to be a common carrier and offer basic services in an area can receive USF moneys. But, unless that carrier also is willing to assume carrier of last resort obligations, their so-called commitment to universal service will be an illusory promise.

Competitive markets need competitively neutral universal service requirements. You can't have one entity with one set of obligations to serve, while allowing other entities to receive high cost support that have a lesser set of obligations. That is not a competitively-neutral result and violates the Joint Board's newly-recommended principle.

So, why isn't the Joint Board recommendation ready for prime time?

Transitioning from a regulated monopoly to a competitive market is difficult. But, regulators cannot try to lessen this difficulty by ignoring their obligations built up under the former mode. On all of the major policy issues addressed in their recommendation — how big is the fund, who pays, who gets support, how costs are determined — the Joint Board refuses to recognize what actually exists.

In summary, if we look at the principles enunciated in the Telecom Act and embraced by the Joint Board, the recommendations fail to measure up against three of them — equitable and nondiscriminatory contributions; specific, predictable, and sufficient support mechanisms; and competitively neutral application of the rules. Because of these fatal shortcomings, the Joint Board recommendation simply is not ready for prime time.